

The INFLATION COMPLICATION

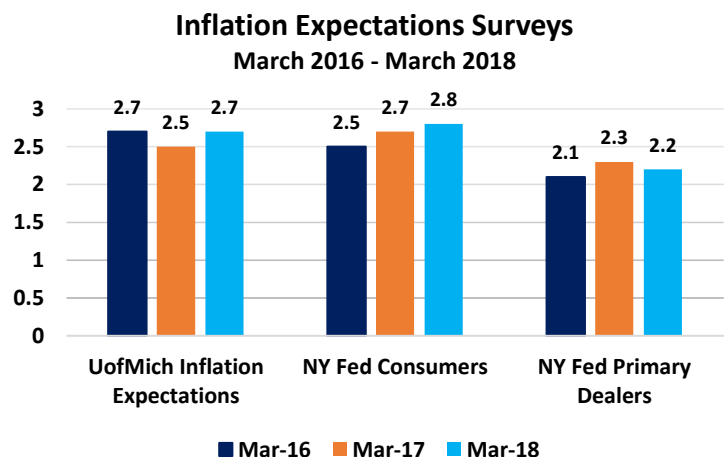
Market Viewpoint: May 4, 2018

To paraphrase the Rolling Stones, *the Fed can't always get what it wants... But it has tried so hard, that it just might get... A lot more than it needs.*

The Federal Reserve has said for years that it wants to get inflation in the U.S. back to 2% per year. Some indicators are already showing inflation rates higher than that. But, the Fed persists with its fixation on the core personal consumption expenditures (“PCE”) deflator as a superior measure. That number has been stuck below 2% since May 2012. The trend of the inflation data, however, may be changing soon.

Some surveys of inflation expectations have already been inching higher, some not. The University of Michigan Inflation Expectation Survey has climbed half a percentage point over the past 15 months to 2.7% for the year ahead. Forecasters at the Philly Fed expect headline CPI inflation to average 2.1% in 2018, unchanged from their last survey. However, they have revised their projections for headline and core PCE inflation in 2018 to 1.9%, up from 1.8% three months ago. The NY Fed's Survey of Consumer Expectations for March showed no change in 1-year and 3-year inflation expectations, which remain at 2.8% and 2.9%, respectively. But the Fed's survey of Primary Dealers showed 39% of those surveyed had a median expectation of 2.2%, in from the beginning of 2018, and the same as this time last year.

Meanwhile, actual headline inflation numbers have been creeping higher. The year-over-year change in the CPI has risen from 2.1% in the first month of 2018 to 2.4% in March. Core inflation, excluding food and energy, rose at a rate slightly above 2.1% in March. On the other hand, March's core PCE, the Fed's preferred measure of inflation, is still coming in a hair below target at 1.9%, but shows an uptrend since hitting 1.3% this past August.



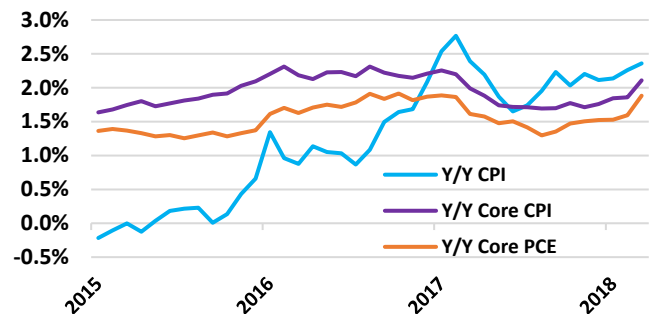
Joseph J. McAlinden, CFA, is the founder of [McAlinden Research Partners \(MRP\)](#) and its parent company, Catalpa Capital Advisors. He has 50 years of investment experience. Mr. McAlinden founded Catalpa Capital in March 2007 after leaving Morgan Stanley Investment Management where he had spent 12 years, serving first as chief investment officer and later as chief global strategist. During his 10 year tenure as chief investment officer, he was responsible for directing MSIM's daily investment activities and oversaw more than \$400 billion in assets. As chief global strategist, he developed and articulated the firm's investment policy and outlook. Prior to Morgan Stanley, Mr. McAlinden held positions as chief investment officer at Dillon Read and as President & CEO of Argus Research. Mr. McAlinden frequently appears in the financial media including Bloomberg Television.

April also saw the unemployment rate drop to a 17-year low of 3.9%. However, wage and job growth numbers should continue to get Phillips curvers talking. According to the BLS, wages rose by only 2.6% YoY in April; however, while government reports of wage and salary gains remain historically low, they are the best in a long time. At the same time, the recent small business report from the NFIB showed that with labor force participation near historic lows, 57% of small businesses are hiring or planning to hire; but, a large majority (88%) of them reported difficulties finding qualified candidates. The NFIB's report of higher worker compensation was mostly unchanged at a net 33%, the highest reading since 2000.

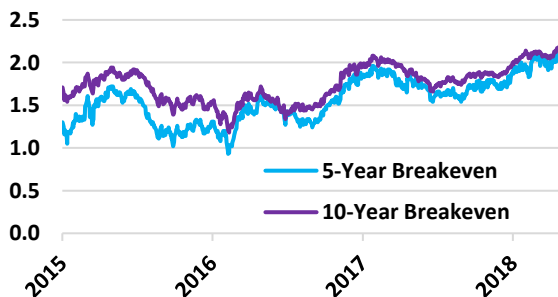
Even the Federal Reserve acknowledges that inflation is beginning to creep higher. As expected, the Federal Open Market Committee held the funds rate at a target of 1.5%-1.75% at its meeting this month. However, the committee noted that "overall inflation and inflation for items other than food and energy have moved *close to 2 percent*." That's a significant change from their March post-meeting statement that the indicators "*have continued to run below 2 percent*."

More important, inflation expectations in the bond markets have been rising faster than the surveys and the latest actual data. Bond market inflation expectations are measured by the so-called *breakeven rates*, a measure of expected inflation derived from comparing a traditional treasury's coupon rate to one with the same maturity date, but whose principal value automatically adjusts for inflation such as treasury inflation-protected securities (TIPS).

CPI & Core PCE
Jan 2015 - Apr 2018



Breakeven Rates
Jan 2015 - Apr 2018



It is where the rubber meets the road in the daily trading of hundreds of billions of dollars in bonds, and a much better estimate of the inflation outlook as seen by players who have to put their money where their mouth is every day. Looking at breakeven rates cuts through the cacophony of expert commentary and opinion, honing in on the bottom line of expectations of real bond money managers, issuers, and other professional buyers and sellers.

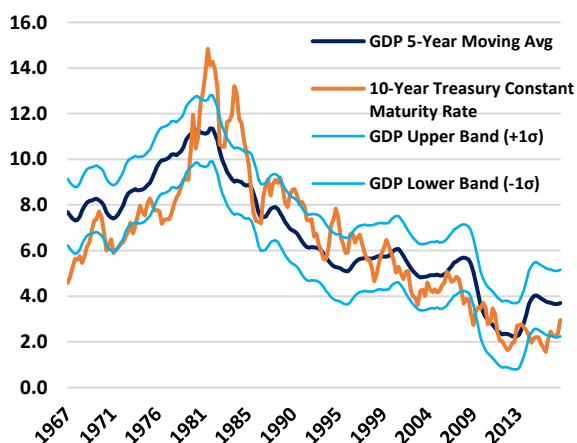
Over the past two years, the breakeven rate on the 10-year treasury has almost doubled. In the last few months, rates have risen modestly, helped along by gains in the producer price index. The monthly average rate on 5 and 10-year breakevens are up 16.1% and 12.5%, respectively, from this time last year. Indeed, it is the rising inflation expectations that have pushed bond yields up to their current trend. Meanwhile, expected "real rates of return" have not budged, notwithstanding all of the bluster from the administration about real growth rising to 3-5%.

In late April, the 10-year Treasury yield flirted with a three handle, closing above 3% on April 25th for the first time in more than 4 years before settling back below 3% the next day. The last time that happened, it soon retreated all the way back down to a new cycle low of 1.37%. This time, MRP does not expect such a retreat. Since hitting its trough, the yield has now more than doubled to its current level of 2.9%, in less than two years.

Moreover, several powerful forces are driving the yield higher this time around. Earlier in the year, MRP had outlined a confluence of [four disruptions](#) that we thought would hit the bond market this year: the Fed shrinking its balance sheet; the Fed sticking to, rather than, backing away from its planned path for Fed Funds; the behavior of a Powell-led Fed in a “heating up” economy, which could be very different from market expectations, and, global growth already pushing up rates [around the world](#). The combination of these disruptions could push historically low bond yields upwards substantially from their below-normal levels. And a stronger than expected acceleration in inflation would be a new complication.

In fact, MRP believes bond yields are in the process of moving in the direction of the US' nominal growth rate, which itself may be about to accelerate. The five-year moving average of nominal GDP growth is 3.7%; but the latest data (Q1 2018) shows a 4.8% gain from the prior year. If the Administration hits its real GDP growth goals and the Fed were to hit its inflation target, nominal GDP growth of 5-7% would, in time, suggest a 4 or 5 handle down the road.

YoY GDP vs 10yr Treasury
1967 - 2017 (Quarterly)



In mid-February, as the S&P was 8% off its January 26th high, [we wrote](#): “MRP’s view is that, in the short term, treasury yields will stabilize around 3% for a while, Q1 earnings will be a blow out, and the stock market will rally and make a possible double top sometime in Q2. But, when interest rates resume their upward path, volatility will emerge once again.”

Bond yields moving to a 3 or, eventually, a 4-5 handle would be a serious headwind for the bull market of the past decade. Over time, higher rates mean a higher discount rate applied to future earnings streams. In other words, when rates go up, P/Es go down.

Joe Mac

For MRP’s research disclaimer, please go to www.mcalindenresearchpartners.com/disclaimer.html